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UNCLAS SECTION 01 OF 02 MASERU 000589

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SUBJECT: LESOTHO: INFLATION ON THE RISE

REF: PRETORIA 3779

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¶1. SUMMARY: Over recent months, inflation has become a serious issue in Lesotho. A decline in cereal production, resulting from the worst drought in a decade, and surging oil prices are exerting a strong upward pressure on food prices and the overall consumer price index. Consumer inflation, diminishing purchasing power, perpetual wage and price distortions posed by the neighboring South African economy, and the impact of HIV/AIDS on the health and productivity of Lesotho's workforce raise questions about the country's general macroeconomic outlook. END SUMMARY.

Inflation High, Food Leads Price Surge

¶2. Lesotho's primary inflation measure, the Consumer Price Index (CPI), jumped to 8.7% year-over-year in September. In August, the overall annual inflation rate reached 8.2%. Each of these high inflation statistics appear to be driven by increasing food prices, currently running at 15% above 2006 levels, including significant spikes in the wholesale price of grain.

¶3. Food prices comprise 39.8% of Lesotho's CPI basket, and changes in the food price level have a strong influence on the overall inflation rate. The most important factors driving up the price of food is the 2006-2007 drought and failed harvest, as well as surging energy prices in international markets. A sampling of year-over-year CPI components reveals varied inflation rates for different sections of the basket:

Restaurants	20.7%
Food and non-Alcoholic Beverages	15.1%
Gas and Other Fuel	8.8%
Clothing and Food Wear	4.4%

The Impact of South Africa

¶4. According to media sources (reftel), the inflation rate in South Africa leaped to 6.7% in September, exceeding its target band by 0.7%. As Lesotho receives more than 70% of its imports from South Africa, growing inflation in its sole neighbor inevitably influences domestic price developments. Lesotho's interest rates also closely track those in South Africa - with an additional premium for perceived risk in the Mountain Kingdom. On both of these fronts (product prices and interest rates), South African developments are exerting an upward pressure on inflation in Lesotho.

¶5. Since June 2007, the South African Reserve Bank has raised its key repo rate by 3.5% points to 10.5% (reftel), resulting in interest rates hikes in Lesotho reaching the current 15.25%. Continuing inflationary trends foreshadow the possibility of additional interest rates hikes in December 2007 and February ¶2008. Adverse price developments, coupled with interest rate hikes, imply reduced personal spending power as earnings will continue to be eroded by rising inflation and higher debt payments (due to increased interest rates). [NOTE: In April, the Government of Lesotho announced a 10% increase in salaries to keep up with inflation, representing an adjusted increase of 1.3%. END NOTE.]

Inflation Spells Trouble

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¶6. COMMENT: Given the fact that Lesotho's current inflationary pressures emanate mainly from food and fuel prices, consumer spending, the main engine of economic growth, may slow. Retailers generally pass on the bulk of price increases in food commodities and fuel directly to consumers -- posing additional burdens on the coping mechanisms of impoverished Basotho households. While the Government of Lesotho is aware of these developments, the root causes of inflation -- drought, international fuel prices, and decisions by foreign central banks -- seem largely outside of its control. The economic impact of the country's HIV/AIDS pandemic poses additional challenges to the general public, particularly the most vulnerable communities already struggling to absorb growing inflation. END COMMENT.
MURPHY